No. 269

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In the Supreme Court of the United States

OCTOBER TERM, 1957

R. M. and ALMA L. GUNN; ARTHUR T. and MARGUERET SAUNDERS; R. E. and PEGGY Q. STANFORD; AINSLIE and MAE FRANCES PERRAULT; and ALLIED PAINT MANUFACTURING CO., *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

BRIEF FOR THE RESPONDENT IN OPPOSITION

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INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statutes involved	2
Statement	2
Argument	5
Conclusion	9
Appendix	10

CITATIONS

Cases:	
Bair v. *Commissioner*, 199 F. 2d 589	5, 7
Camp Wolters Enterprises v. *Commissioner*, 230 F. 2d 555, certiorari denied, 352 U. S. 826	7
Cohen v. *Commissioner*, 148 F. 2d 336	5
Dobkin v. *Commissioner*, 15 T. C. 31, affirmed, 192 F. 2d 392	6
Gooding Amusement Co. v. *Commissioner*, 236 F. 2d 159, certiorari denied, 352 U. S. 1031	5, 7
Gregg Co. of Delaware v. *Commissioner*, 239 F. 2d 498, certiorari denied, 353 U. S. 946	7
Houck v. *Hinds*, decided December 4, 1953 (W.D. Okla.)	4
Houck v. *Hinds*, 215 F. 2d 673	4
John Kelley Co. v. *Commissioner*, 326 U. S. 521	5
Kraft Foods Co. v. *Commissioner*, 232 F. 2d 118	7
Miller's Estate v. *Commissioner*, 239 F. 2d 729	7
Mullin Building Corp. v. *Commissioner*, 9 T. C. 350	7
Mullin Building Corp. v. *Commissioner*, 167 F. 2d 1001	6
Perrault v. *Commissioner*, 25 T. C. 439	1
Root v. *Commissioner*, 220 F. 2d 240	5
Rowan v. *United States*, 219 F. 2d 51	7
Schnitzer v. *Commissioner*, 13 T. C. 43	7
Schnitzer v. *Commissioner*, 183 F. 2d 70	5
Sogg v. *Commissioner*, decided October 4, 1950 (T. C.), affirmed 194 F. 2d 540	7
Sun Properties v. *United States*, 220 F. 2d 171	7
Statutes:	
Internal Revenue Code of 1939:	
Sec. 23(b) (26 U.S.C. 1952 ed., Sec. 23(b))	10
Sec. 112(a) (26 U.S.C. 1952 ed., Sec. 112(a))	10
Sec. 112(b)(5) (26 U.S.C. 1952 ed., Sec. 112(b)(5))	10
Sec. 115(a) (26 U.S.C. 1952 ed., Sec. 115(a))	11

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OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. 4a-26a) are reported at 25 T. C. 424.[1] The opinion of the Court of Appeals (Pet. App. 1a-4a) is not yet reported.

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[1] On appeal there was also included that part of the decision of the Tax Court in *Perrault* v. *Commissioner*, 25 T. C. 439, 440, which by agreement was made to depend upon the result in the principal case.

JURISDICTION

The judgments of the Court of Appeals were entered on April 19, 1957. (Pet. App. 31a-34a.) The petition for a writ of certiorari was filed on July 12, 1957. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTION PRESENTED

The partners in a going business transferred its assets to a newly-formed corporation of which they became the only stockholders. The corporation in the following years made payments out of its earnings to the stockholders proportionate to their stock interest. The question is whether the courts below erred in holding that, under the facts of this case, those payments were taxable as dividends.

STATUTES INVOLVED

The statutes involved, Sections 23(b), 112(a) and (b)(5), and 115(a) of the Internal Revenue Code of 1939, appear in the Appendix, *infra*, pp. 10-11.

STATEMENT

The facts relevant to the petition for certiorari, as found by the courts below, may be summarized as follows:

From June, 1942, through September, 1946, the taxpayers Raymond M. Gunn, Arthur T. Saunders, Robert E. Stanford, and Ainslie M. Perrault, together with George C. Houck, Jr., were engaged in the business of manufacturing and selling paint. They operated as a limited partnership, the Allied Paint Company, in which their distributive interests were as follows: Gunn, 17.5%; Saunders, 12.5%; Stanford,

12.5%; Perrault, 55.0%; Houck, 2.5%. (Pet. App. 9a.)

In September and October of 1946, the partners transferred the assets of the business to a newly-formed corporation, the Allied Paint Manufacturing Company. Its total authorized capital stock was $50,000; $1,000 was paid in cash and the remaining $49,000 was subscribed for. In return, the individual taxpayers[2] received stock in the corporation and its promissory notes, totalling $582,773.54; $50,000 payable on December 31, 1946, and the balance payable in annual installments over a ten-year period. Both the notes and the stock were issued to the five stockholders in the same proportion as their interests in the partnership.[3] (Pet. App. 13a-15a.) No formal dividends as such were paid in 1946, 1947, or 1948 by the corporation to the stockholders. (Pet. App. 21a.) Payments of the notes due December 31, 1946, and annual installments on the other notes were made by the corporation until 1952. (Pet. App. 19a.)

The taxpayers treated the payments received on their notes in 1946 and 1948 as the proceeds of a sale, and reported long-term capital gains on the install-

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[2] The wives did not participate.

[3] The transaction took the form of the organization of the corporation by taxpayers' attorneys, with the attorneys as stockholders, a distribution of partnership assets to the partners, a sale of the assets by them to the corporation, followed by the partners becoming stockholders in the corporation. (Pet. App. 13a-16a.) The courts below found that what occurred "was in substance a single transaction whereby the partners subscribed for stock in a new Corporation and transferred their partnership property to the Corporation for notes, with both the stock and the notes representing the same proportionate interest in the Corporation as they previously held in the Partnership." (Pet. App. 21a.) Taxpayers here do not question this finding. (Pet. 9, fn. 21.)

ment basis. The Commissioner determined that the payments were dividends from the corporation. The Commissioner also disallowed the corporation's deduction of interest attributable to the notes in its fiscal years 1947, 1948, and 1949, and determined that for depreciation purposes in those years the basis of the depreciable assets transferred was the same as the former partnership's basis. (Pet. App. 20a.)

One of the stockholders, George C. Houck, Jr., paid the deficiency assessed on him and sued for a refund in the United States District Court for the Western District of Oklahoma. That court decided in favor of the Collector. *Houck* v. *Hinds*, decided December 4, 1953 (1954 P-H, par. 72,405). On appeal, the United States Court of Appeals for the Tenth Circuit affirmed the judgment of the District Court. *Houck* v. *Hinds*, 215 F. 2d 673. The other taxpayers, in the present case, petitioned the Tax Court for a redetermination of the deficiencies assessed. The Tax Court, upon its own review of the evidence submitted, held that the payments by the corporation to its stockholders were taxable as dividends, that the corporate taxpayer could not deduct interest accrued on the notes, and that under Section 112(b)(5) of the Internal Revenue Code of 1939 the basis for depreciation of the assets transferred to the corporation was their basis in the hands of the transferors. (Pet. App. 22a-26a.) The Court of Appeals affirmed, relying on its decision in *Houck* v. *Hinds, supra*. (Pet. App. 1a-4a.)

ARGUMENT

The evidentiary facts in this case are not in dispute. The partners in a going business transferred its assets to a newly-formed corporation of which they became the only stockholders. The corporation in the following years made payments out of its earnings to its stockholders proportionate to their stock interest. The controversy is as to the nature of those payments. The Commissioner contended that the substance of the transaction resulted in a distribution out of corporate earnings to the stockholders, taxable as dividends. Taxpayers, relying on the form of the transaction, contended that the payments were payments on the purchase price of assets bought by the corporation from individuals who, coincidentally but irrelevantly, happened to be its stockholders. The courts below held that the payments were in fact dividends.

Whether or not a corporate distribution is a dividend or is repayment of a loan or interest on a loan is a question of fact to be determined by the trial court. Otherwise stated, whether the issuance of a so-called debt instrument by a corporation to its stockholders is intended to reflect a real indebtedness as distinguished from a capital interest presents a question of ultimate fact in each case, depending on all the relevant circumstances, no single factor being conclusive. *John Kelley Co. v. Commissioner*, 326 U. S. 521; *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159 (C. A. 6th), certiorari denied, 352 U. S. 1031; *Root* v. *Commissioner*, 220 F. 2d 240 (C. A. 9th); *Schnitzer* v. *Commissioner*, 183 F. 2d 70 (C. A. 9th); *Bair* v. *Commissioner*, 199 F. 2d 589 (C. A. 2d); *Cohen* v. *Commissioner*, 148 F. 2d 336 (C. A. 2d); *Mullin*

Building Corp. v. *Commissioner*, 167 F. 2d 1001 (C. A. 3d).

In this case, the courts below considered all the circumstances, the Tax Court pointing out that the notes were in direct proportion to the stock subscriptions and to the partners' interests in the partnership, that the notes were issued in connection with the creation of the corporation, that the corporation had a form-capital of only $1,000 in cash and $49,000 in stock subscriptions, and that the assets represented by the notes represented almost all of the assets put to the risk of the business. (Pet. App. 23a-24a.) Contrary to the statements in the petition (pp. 2, 14, 15), the courts below did not base their decisions solely on the ratio of indebtedness to equity capital, but considered all of the circumstances.

If taxpayers are petitioning for certiorari on the ground that the courts below erred in basing their decisions solely on the ratio of indebtedness to capital, the answer is that that is not what the courts did. If taxpayers are arguing that the courts below properly considered all the circumstances of this particular case but ought to have reached a different result, taxpayers are merely quarreling with the weight given by the courts to the various factors, and are here seeking a second appellate review of a factual decision.

Taxpayers' argument, however, appears to be that it was error for the courts below to give any weight at all to the ratio of indebtedness to equity capital in determining that the notes represented a proprietary interest in the corporation. (Pet. 16-20, 21-23, 28-32.) The courts of appeals, however, have uniformly treated that ratio as a factor to be considered (*Dobkin*

v. *Commissioner*, 15 T. C. 31, affirmed, 192 F. 2d 392 (C. A. 2d); *Bair* v. *Commissioner*, 199 F. 2d 589 (C. A. 2d); *Schnitzer* v. *Commissioner*, 13 T. C. 43, affirmed, 183 F. 2d 70 (C. A. 9th); *Root* v. *Commissioner*, 220 F. 2d 240 (C. A. 9th); *Mullin Building Corp.* v. *Commissioner*, 9 T. C. 350, affirmed, 167 F. 2d 1004 (C. A. 3d); *Sogg* v. *Commissioner*, decided October 4, 1950 (1950 P-H T. C. Memorandum Decisions, par. 50,251), affirmed, 194 F. 2d 540 (C. A. 6th); *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159 (C. A. 6th), certiorari denied, 352 U. S. 1031) although in particular cases they have concluded that there was not in fact a so-called "thin capitalization" (*Kraft Foods Co.* v. *Commissioner*, 232 F. 2d 118, 127 (C. A. 2d); *cf. Gregg Co. of Delaware* v. *Commissioner*, 239 F. 2d 498 (C. A. 2d), certiorari denied, 353 U. S. 946; *Miller's Estate* v. *Commissioner*, 239 F. 2d 729, 733 (C. A. 9th)).

Certain language in the opinion in *Rowan* v. *United States*, 219 F. 2d 51 (C. A. 5th), criticizes the Commissioner's reliance on "thin capitalization," but the opinion specifically agrees with other courts that where there are other factors to show that the noteholder interest in a corporation is a proprietary one the ratio of debt to equity capital is one of the relevant factors to be considered. The opinion in *Sun Properties* v. *United States*, 220 F. 2d 171 (C. A. 5th), went no further. Furthermore, in a later decision, *Camp Wolters Enterprises* v. *Commissioner*, 230 F. 2d 555, 559, certiorari denied, 352 U. S. 826, the Fifth Circuit agreed that notes given to stockholders may represent an interest in a corporation where the notes "did not evidence an isolated transaction of purchase and sale, having its inception after the forming and

launching of the corporation." Accordingly, there is no conflict of circuits on this issue.

Nor does this case present any important question of federal law calling for resolution by this Court. Taxpayers' argument (Pet. 20-23) comes down to little more than a complaint that they cannot predict with absolute certainty the tax consequences of their acts, and that the courts may disappoint a taxpayer's expectations. Such a result, however, is inherent in any case where the decision depends upon the facts of the particular transaction. The problem faced by taxpayers and by the Commissioner in this type of situation is the same as meets them throughout the structure of the tax system.

Furthermore, the certainty which taxpayers seek could come only from a rule that in all cases the form of a transaction between the stockholders and their corporation is to be conclusive in determining its substance. Nothing less would meet their objections to the decisions below. But the principle that form does not control substance is firmly imbedded in tax law.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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August, 1957.

APPENDIX

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, * * *.

(26 U.S.C. 1952 ed., Sec. 23(b).)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

* * * * *

(5) *Transfer to corporation controlled by transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

* * * * *

(26 U.S.C. 1952 ed., Sec. 112(a), (b)(5).)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year * * *.

* * * * *

(26 U.S.C. 1952 ed., Sec. 115(a).)

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